

General Information Letter: Partnership with no assets or employees in Illinois, and whose only Illinois activities are carried out by independent contractors will have no Illinois sales factor numerator.

August 14, 2001

Dear:

This is in response to your letter dated July 17, 2001, in which you request a letter ruling. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us.

In your letter you have stated the following:

Pursuant to 2 Ill. Admin. Code Sec. 1200.120, our client ("PARTNERSHIP CO.") requests the Department of Revenue (the "Department") issue a General Information Letter (the "GIL") interpreting the application to PARTNERSHIP CO. of the Illinois income and replacement tax laws and the Department's regulations administering the same in the financing transaction engaged in by PARTNERSHIP CO.

I. Administrative Matters

- 1) An original Form IL-2848, Power of Attorney, is not enclosed since we are not requesting a binding Private Letter Ruling.
- 2) This request regards the application of the Illinois income and replacement tax laws.
- 3) The GIL is not requested with regard to a hypothetical or alternative proposed transaction. The GIL is requested with regard to actual transactions currently and formerly taking place.
- 4) PARTNERSHIP CO. is not currently under audit by the Department on these transactions; however, certain affiliates of PARTNERSHIP CO. have been audited or are currently undergoing audit by the Department on transactions unrelated to those discussed herein.
- 5) At this time, we are not enclosing any documents pertinent to this request.
- 6) To the best of the knowledge of employees of affiliates of PARTNERSHIP CO., and to the best of my own knowledge, the Department has not previously ruled on the application of the Illinois income and replacement tax laws to PARTNERSHIP CO. under the facts as presented.

II. Issues Presented

1. Whether the activities of ABC, DEF, WXYZ, or third party banks or financial institutions, as set forth below, will cause any gross receipts of PARTNERSHIP CO. to be characterized as Illinois sales.
2. If PARTNERSHIP CO. does not have any Illinois sales, whether it is obligated to remit Illinois personal property replacement tax on its net income.

III. Statement of Facts

Our client, which is a partnership, was organized on August 11, 2000, between WXYZ Inc., a Delaware corporation located outside of Illinois ("WXYZ"), and DEF LLC, a Delaware limited liability company located outside of Illinois ("DEF").

The purpose and functions of PARTNERSHIP CO. are to take any lawful actions, including without limitation (i) to issue and sell certain securities, (ii) to grant certain options to ABC, Inc., a Delaware corporation with headquarters located in Illinois ("ABC"), (iii) to acquire certain notes from ABC, (iv) to sell any of the partnership property, and (v) to make any other investment in permitted investments.

On August 11, 2000, pursuant to the stated purposes and functions of PARTNERSHIP CO., the following transactions were entered into:

1. A Certificate Evidencing Common Securities of PARTNERSHIP CO. was issued to WXYZ acknowledging that it is the registered owner of 15,000 common securities of PARTNERSHIP CO. representing common beneficial interests in the assets of PARTNERSHIP CO. and designated the Common Securities (initial principal amount \$1,000 per Common Security).
2. A Certificate Evidencing Series A Preferred Securities of PARTNERSHIP CO. was issued to DEF acknowledging that DEF is the registered owner of 485,000 Preferred Securities of PARTNERSHIP CO. representing a beneficial interest in the assets of PARTNERSHIP CO. and designated the Preferred Securities (initial principal amount \$1,000 per Preferred Security).
3. ABC and PARTNERSHIP CO. entered into an Option Agreement wherein PARTNERSHIP CO. granted to ABC an irrevocable and unconditional commitment, upon exercise of the Option by ABC, to issue to ABC 100% of the Series B Preferred Securities of PARTNERSHIP CO. In exchange for the grant of a Call Option, ABC issued a Junior Subordinated Note to Bank X, a New York state banking corporation, in a principal amount exceeding \$1 billion. The note is a zero coupon note and has a term of 11 years (the "Junior Zero Coupon Note").
4. ABC issued a Junior Subordinated Note to Bank X in the principal amount of \$500 million. The note bears interest at a market rate for a term of 10 years (the "Junior Subordinated Note").

As indicated, PARTNERSHIP CO. is a partnership. As a partnership, PARTNERSHIP CO. is not subject to federal income tax. Instead, its partners are required to take into account their respective allocated share of income, gains, losses, deductions, and credits. PARTNERSHIP CO.'s income initially consists of income on the Junior Subordinated Note and the Junior Zero Coupon Note and thereafter on the assets held by PARTNERSHIP CO. from time to time. PARTNERSHIP CO.'s expenses consist primarily of fees paid to both related and unrelated entities.

The partners of PARTNERSHIP CO. are WXYZ and DEF. Neither WXYZ nor DEF own or lease offices or employ personnel in Illinois. One or both of the partners operate from leased offices located in a state other than Illinois. In addition, one or both of the partners employ personnel at an office located outside of Illinois.

PARTNERSHIP CO. does not have any employees in Illinois or elsewhere. Likewise, PARTNERSHIP CO. does not own or lease any real or tangible personal property in Illinois or elsewhere. Lastly, PARTNERSHIP CO. does not maintain a physical business location in Illinois.

In view of the fact that PARTNERSHIP CO. has no employees or tangible assets, various administrative functions, e.g., maintaining the books of PARTNERSHIP CO. for financial statement reporting purposes and preparing and filing tax returns, are performed by employees of ABC from a location in Illinois.

IV. Statement of Authority in Support of PARTNERSHIP CO.

There are no direct cases or Illinois Private Letter Rulings addressing the specific facts described herein.

V. Discussion

A. Applicable Law

Section 304 of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et. seq.*) provides a general framework for apportioning a taxpayer's business income to Illinois by formula. The applicable formula to be applied in the instant matter provides that, for calendar years ending on or after December 31, 2000, business income shall be apportioned to Illinois using an apportionment formula comprised solely of the sales factor.

In computing the sales factor, IITA section 304(a)(3)(C) provides:

Sales, other than sales of tangible personal property, are in this State if:

- (i) The income-producing activity is performed in this State; or
- (ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-

producing activity is performed within this State than without this State, based on costs of performance.

86 Ill. Admin. Code Section 100.3370(c)(3)(A) provides:

Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by a person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted by an independent contractor.

86 Ill. Admin. Code Section 100.3370(c)(3)(B) provides:

Cost of performance defined. The term "cost of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person.

B. Application of Law to Facts

PARTNERSHIP CO. is a partnership. As a partnership, PARTNERSHIP CO. is not subject to federal income tax. Likewise, PARTNERSHIP CO. is also not subject to Illinois income tax. Instead, the partners of PARTNERSHIP CO. are required to separately take into account their respective distributive share of income, gains, losses, deductions, and credits.

In general, partnerships earning or receiving income in or as a resident of Illinois are subject to Illinois replacement tax at a rate of 1.5% of the partnership's Illinois net income for the taxable year. 35 ILCS 5/201(c) and (d). The Department has previously ruled that a partnership is required to file an Illinois replacement tax return (Form IL-1065) only if the partnership has net income that is allocable or apportionable to Illinois. See, e.g., Ill. Priv. Ltr. Rul. 86-0723 (Sept. 15, 1986).

As noted, one or both of PARTNERSHIP CO.'s partners operate from leased offices located in a state other than Illinois. In addition, one or both of PARTNERSHIP CO.'s partners employ personnel at an office located outside of Illinois. Accordingly, PARTNERSHIP CO. is engaged in multistate business activities as a result of the activities of one or more of its partners.

As also noted, PARTNERSHIP CO. does not have any employees in Illinois or elsewhere. Likewise, PARTNERSHIP CO. does not own or lease any real or tangible personal property in Illinois or elsewhere. Lastly, PARTNERSHIP CO. does not maintain a physical business location in Illinois.

In addition to the foregoing, neither of PARTNERSHIP CO.'s partners has any employees in Illinois. Likewise, neither of PARTNERSHIP CO.'s partners own or lease

any real or tangible personal property in Illinois. Lastly, neither of PARTNERSHIP CO.'s partners maintain a physical business location in Illinois.

As set forth above, all of PARTNERSHIP CO.'s administrative responsibilities are performed by employees or officers of ABC from offices located in Illinois. As also noted, various administrative functions of PARTNERSHIP CO., e.g., maintaining the books of PARTNERSHIP CO. for financial statement reporting purposes and preparing and filing tax returns, are performed by employees of ABC from a location in Illinois.

In determining whether PARTNERSHIP CO. has performed income-producing activity in Illinois, the applicable regulation provides that such activity must be "directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profits." 86 Ill. Admin. Code Section 100.3370(c)(3)(A). Moreover, it is clearly stated that "[s]uch activity does not include transactions and activity performed on behalf of a person...." *Id.*

The applicable standard is further developed by 86 Ill. Admin. Code Section 100.3370(c)(3)(B), which provides that "costs of performance" are defined as the "direct costs" incurred by a taxpayer in carrying out its business activities.

Under the foregoing provisions, it seems clear that a partnership that has no property or employees in Illinois at any time would not be conducting any income-producing activity in the State and no costs of performance associated with any income-producing activity of that taxpayer would be incurred in Illinois.

Accordingly, no amount paid to ABC, DEF, WXYZ, or third party banks or financial institutions for services performed on behalf of PARTNERSHIP CO. is a direct expense of PARTNERSHIP CO. Therefore, the activities of ABC, DEF, WXYZ, or third party banks or financial institutions cannot result in PARTNERSHIP CO. being deemed to have any cost of performance occurring in Illinois. Likewise, any amount paid to ABC in connection with performing various administrative activities and functions on behalf of PARTNERSHIP CO. cannot result in PARTNERSHIP CO. being deemed to have any cost of performance occurring in Illinois.

In view of the foregoing, the activities of ABC, DEF, WXYZ, or third party banks or financial institutions cannot cause any gross receipts of PARTNERSHIP CO. to be characterized as Illinois sales. Therefore, PARTNERSHIP CO. should not have an obligation to remit Illinois personal property replacement tax on its net income.

* * *

We represent that sufficient reason has been presented for the Department to issue a GIL confirming the tax consequences discussed above. However, if the Department intends to rule that the transactions described herein give rise to an obligation under the Illinois personal property replacement tax, we respectfully request that advance notice of such intent be provided to us so that we may provide needed clarification, information or argument that may yet persuade the Department to issue a GIL as requested. Such notice may be given to the undersigned.

Response

Section 304 of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) provides the framework for apportioning a taxpayer's business income to Illinois by formula. The formula applicable to persons other than insurance companies, financial organizations and transportation companies is provided in Section 304(a) of the IITA, which provides that business income shall be apportioned to Illinois:

by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero. For tax years ending on or after December 31, 1998, and except as otherwise provided by this Section, persons other than residents who derive business income from this State and one or more other states shall compute their apportionment factor by weighting their property, payroll, and sales factors as provided in subsection (h) of this Section.

For purposes of computing the sales factor, Section 304(a)(3)(C) of the IITA provides:

Sales, other than sales of tangible personal property, are in this State if:

- (i) The income-producing activity is performed in this State; or
- (ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on performance costs.

These provisions are explained in more detail by regulation in 86 Ill. Admin. Code Section 100.3370(c)(3)(A), which provides:

Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor.

You have represented that PARTNERSHIP CO. has no tangible assets or employees in Illinois or elsewhere, and that the only activities related to the conduct the business of PARTNERSHIP CO. that will be conducted within Illinois are administrative functions and the maintenance of books and records, all conducted by employees of ABC. Pursuant to 86 Ill. Admin Code Section 100.3370(c)(3)(A), such activities conducted on behalf of PARTNERSHIP CO. cannot constitute income-producing activities of PARTNERSHIP CO. Accordingly, based on the representations made in your letter, PARTNERSHIP CO. will have no income-producing activities within Illinois.

Section 502(a) of the IITA provides:

A return with respect to the taxes imposed by this Act shall be made by every person for any taxable year:

- (1) For which such person is liable for a tax imposed by this Act, or
- (2) In the case of a resident or in the case of a corporation which is qualified to do business in this State, for which such person is required to make a federal income tax return, regardless of whether such person is liable for a tax imposed by this Act.

A partnership cannot be a resident. See Section 1501(a)(20) of the IITA. Accordingly, a partnership is required to file an Illinois income tax return only for a taxable year for which it is liable for tax.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel -- Income Tax